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Committee on Transportation and Infrastructure

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Testimony Of
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Good afternoon Chairman Oberstar, Ranking Member Mica, and other Committee Members. Thank you for this opportunity to testify on rail competition and service matters.

Following the passage of the Staggers Rail Act of 1980, which greatly reduced economic regulation of the railroad industry, there were many who felt that the Interstate Commerce Commission should be abolished completely and that rail transportation rates and service should be determined by market forces (subject to the anti-trust laws). However, it was clear to most in Congress that the railroad industry did differ in important ways from other industries and that some degree of economic regulation needed to continue to protect the interests of those shippers who were "captive" to the railroads. The Surface Transportation Board was created to balance the needs of shippers for reasonable rates with the need of the railroads to earn adequate revenues. The overall questions we confront today are "how well has the Board met its charge to balance those interests" and "what is the state of competition in the transportation of bulk commodities that are largely captive to the railroads?"

To some extent the answers depend on where you sit, but clearly there are many who believe that the Board could do more to promote competition, ensure reasonable rates for captive shippers, and improve the reliability and quality of railroad services.

In the early years of the Surface Transportation Board, the agency continued to focus on ensuring that the railroads regained their financial health. In addition to decisions that allowed the carriers to capitalize, through differential pricing, on routes where shippers were captive, the Board also approved mergers of large railroads paying less attention to competitive concerns than to the perceived opportunities for the merging carriers. Pressure from the Congress eventually resulted in the Board's declaring a moratorium on major rail mergers and in the establishment of new merger guidelines that promised to take more account of the competitive impacts of railroad consolidations.

Over the past 3 years, the Board has held a number of hearings on issues related to railroad competition. On October 19, 2005, the Board held a hearing on the state of the railroad industry since the passage of Staggers. The testimony was near unanimous that the industry has largely recovered

from the financial malaise that plagued it during the 1960s and 1970s. The Board also has held hearings and has undertaken a number of initiatives aimed at balancing the scales between shippers and railroads. Let me briefly outline some of the areas where I believe that progress has been made.

First, fuel surcharges. The railroads were calculating fuel surcharges as a percentage of the rates they charged their customers. This meant that captive shippers, who already paid higher rates, had to also pay higher fuel surcharges despite the fact that their shipments did not necessarily require greater fuel usage. The Board found this to be an unfair practice and directed the railroads to compute the surcharges to more closely reflect actual fuel consumption.

Second, access to rate relief. Shippers have long complained that the Board's procedures were too time consuming and too costly. The Board's procedures for adjudicating rate cases (the stand alone cost test) is founded on accepted economic principles and has been approved (if indeed not required) by the courts. The cost of bringing a rate case under the Board's stand alone cost guidelines can cost a shipper several million dollars and the case can take several years to be decided. Even those shippers, who can

justify the expense of bringing a rate case before the Board, generally will either gain no rate relief or a reduction in the proposed rate much below that which they had desired. Shippers whose traffic does not justify the expense of bringing a case under the stand alone cost guidelines believe they have no access to the Board for rate relief.

The Congress more than 20 years ago directed the Board's predecessor, the ICC, to develop simplified, less costly procedures for adjudicating small rate cases. The Board has now acted to address both the cost and timeliness issues in large rate cases, as well as procedures and standards for small rate cases. In October 2006, the STB issued new large rate case guidelines that were designed to take out a significant amount of the time and cost to bring a case under the SAC process. On September 5, 2007, the Board issued new procedures for bringing cases before the Board that do not warrant the expense of a full SAC proceeding. These new rules give shippers the option of selecting how they want to proceed to challenge their rates, but set limits on recovery depending on the process selected. Hopefully, these changes will provide shippers with better access to the Board. I am committed to monitoring the results of these initiatives to see that they work as intended.

In the first test of our new guidelines for large rate cases, the shippers apparently were disadvantaged by the changes. Because of this possibility, the Board has taken the nearly unprecedented step of allowing them to refile their case.

Third, cost of capital. The Board has consistently found that the nation's railroads are "revenue inadequate" despite the fact that Wall Street has found the railroads to be profitable. One of the reasons for this disparity lies in the approach that the Board has taken to determine revenue adequacy. More than 20 years ago, the Board adopted a "Discounted Cash Flow" (DCF) methodology to determine the cost of equity capital. However, over the years, this approach has lost favor with the finance community and the DCF method has long been abandoned by most other agencies that need to make such a calculation. On August 14, 2007, the Board announced a proposed change that could, if adopted, reconcile the Board's estimation of the revenue adequacy of the railroads with that which prevails on Wall Street.

At the same time, there are other areas where the Board has not yet made as definitive a commitment to change. Several areas are of particular concern to me.

Paper Barriers. The Board has been examining the question of what to do about so-called "paper barriers," otherwise known as interchange commitments. These provisions arise when a Class I railroad sells or leases some of its light density trackage to a small or new short line railroad. Often the short line pays little or nothing for the right to haul the traffic, but it must agree to interchange the traffic only with the Class I that leased or sold it the track. Interchanging with another railroad would result in severe penalties. I find this practice to be anti-competitive and I have dissented from the majority in several cases where paper barriers were contained in the sales or lease agreements.[1] What is particularly troublesome to me is that these restrictions on the short lines' ability to interchange with other carriers, and thereby offer shippers a competitive option, go on in perpetuity. Just as new entrants have been the source of competition for legacy carriers in the airline industry, so too could these new carriers become the source of competition in the rail industry in the future.

[1] Paducah & Louisville Ry. – Acquisition – CSX Transp., Inc., STB Finance Docket No. 34738 (STB served Nov. 18, 2005) (Comm'r Mulvey dissenting, at 6-7); Columbus & Ohio River R.R. – Acquisition and Operation Exemption – Rail Lines of CSX Transp., Inc., STB Finance Docket No. 34540 (STB served Nov. 18, 2005) (Comm'r Mulvey dissenting, at 9); Indiana & Ohio Centr. R.R. – Acquisition and Operation Exemption – CSX Transp., Inc., STB Finance Docket No. 34536 (STB served Aug. 23, 2005) (Comm'r Mulvey dissenting, at 9-10); Buckingham Branch R.R. – Lease – CSX Transp., Inc., STB Finance Docket No. 34495 (STB served Nov. 5, 2004) (Vice Chr. Mulvey dissenting, at 13).

Status of Competition. I am also concerned about the state of competition overall in the railroad industry. The Government Accountability Office has recently reported on the status of competition in the rail industry, and I will not repeat its findings here. I did, however, believe that the study inaccurately claimed that the extent of captivity was declining, implying that there were fewer captive shippers than previously. Even if relative captivity (i.e., the percentage of traffic that is captive) has declined, there is no evidence that competitive options have increased for captive shippers. Although the GAO admits that the approach it took to measuring captivity left much to be desired, I believe that the implications drawn do not comport with reality. The GAO also suggested that the STB undertake a study of competitiveness in the railroad industry. The Board, rightfully I believe, initially declined to follow the GAO's recommendation because we lacked the resources. However, the Board has recently contracted to have a study done in response to GAO's suggestions by a private consulting firm, Christensen Associates. Although this is a well-regarded economic consulting firm, I regret that our resources were not committed to the study authorized in the SAFETEA-LU bill which would have focused more on how well the Board has handled its mission.[2] The study requested in

[2] Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users (SAFETEA-LU),

SAFETEA-LU would have been undertaken by the Transportation Research Board, an arm of the National Academy of Sciences.

Investment in Railroads. The overall financial condition of the railroad industry has improved dramatically over the past few years, so much so that it has led to increased interest on the part of private equity firms or hedge funds. These types of investors are often into investments to maximize short term gains for their shareholders. What is of most concern to me would be an attempt by a hedge fund to purchase a significant stake in a railroad, followed by divestiture of the railroads' assets, deferred maintenance, and disinvestment in capital improvements. These actions could result in deterioration of service to shippers and then perhaps lead to a failing firm. The Board does not appear to have any authority under existing law to limit such investments.

Without projecting the outcome of any particular proceeding that might come before us, and aside from recent initiatives we have completed or have pending before us, I have several suggestions for improving rail competition and service.

Pub. L. No. 109-59, sec. 9007 (2005).

One common theme we do hear from all rail stakeholders – albeit expressed in different ways – is that there needs to be more investment in rail infrastructure. It seems that the railroads alone will not be capable of making the levels of investment needed, given the capital intensity of the industry. If we, as a nation, are serious about shifting traffic from our highways to rails, we need to devote more public money into our rail infrastructure. While the railroads favor an investment tax credit, I personally believe the amounts that will be needed will be far greater than what an ITC would realistically produce. A railroad trust fund of the type recommended by former Representative and T&I Committee member Bill Lipinski, could generate the monies that will be required to upgrade and build our nation's rail transportation infrastructure.

Further, I believe that the Board must adjust the focus of its operations to better reflect changing circumstances. For example, the Board currently exercises regulatory oversight over about a third of all railroad traffic. Most traffic is exempt from our regulation because it is presumed to be competitive with other modes of transportation or because it moves under contract. In the case of the latter, railroad/shipper agreements have evolved

so that the line between contract and tariff carriage has become blurred. The Board is currently examining how and whether it needs to clarify the distinction between the two. With respect to exempt traffic, it is best that traffic for which rates can be determined by the competitive marketplace not be subject to economic regulation. That type of regulation proved disastrous before the transportation industries were largely deregulated. However, times change and as they change so does the competitive landscape. I believe we need to look at existing class exemptions periodically to determine whether exemptions that are premised on the availability of intermodal competition remain warranted. Many of these exemptions were sought and granted in the 1980's when the transportation landscape was quite different than it is today.

Finally, to ensure that the Board has the requisite power to take action on issues of concern to the industry and its stakeholders, the Congress may want to consider returning a general power to investigate to the Board. Currently, under 49 U.S.C 11701, the Board may begin an investigation on a potential violation of the rail portions of its statute "only on complaint". It may be appropriate to revise this language by striking "only" and adding "or on its own initiative." If the Congress wants the Board to continue to

actively seek out problems, and to solve them, guidance in this form would be helpful.

Thank you for the opportunity to testify today. I look forward to answering any questions you may have.